Supreme Court, U.S.
FILED
JUL 1 1988
JOSEPH F. SPANIOL, JR.
CLERK

No. 87-984

In the Supreme Court of the United States

OCTOBER TERM, 1988

SHELL OIL COMPANY, APPELLANT

v.

THE IOWA DEPARTMENT OF REVENUE, APPELLEE

On Appeal from the Supreme Court of Iowa

REPLY BRIEF FOR THE APPELLANT

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I.

The central premise of the opposing briefs is that Congress's enactment of the state tax prohibition in the OCSLA did nothing that the Constitution of its own force did not already do. Iowa and the Solicitor General express this proposition in a variety of ways: that the OCSLA merely codified the principle against extraterritorial state taxation that is embodied in the Due Process and Commerce Clauses (see, *e.g.*, Iowa Br. 13, 39; U.S. Am. Br. 5, 16-17, 19, 23); that formula apportionment satisfying constitutionally-required minimum standards necessarily complies with the OCSLA, and therefore that Iowa, by virtue of such apportionment, is taxing only in-state and not OCS income (Iowa Br 11, 19, 21; U.S. Am. Br. 7-11); and that Shell is seeking to use a taxing

method that the Court has held is not required by the Constitution (U.S. Am. Br. 5, 12, 17-18).

As explained in our opening brief (at 42-44), that view of the statute is fundamentally flawed. It treats the OCSLA—which Congress adopted after long and careful consideration—as meaningless surplusage that duplicates existing constitutional requirements. Between 1947 and 1950, the decisions of this Court held that the federal government and not the states had exclusive jurisdiction over off-shore lands and resources. See Shell Br. 3-4. Those decisions plainly and necessarily established that the states could not extend their territorial jurisdiction to the OCS. If, as the states and the Solicitor General now contend, the OCSLA simply codified the constitutional rule against extraterritorial state taxation, it was a useless and purposeless exercise on which Congress wasted a considerable amount of time and effort. According to our opponents' submission, the rules governing state taxation are no different today than they were in 1950, prior to enactment of the OCSLA.

The Solicitor General attempts to avoid this glaring defect by advancing (U.S. Am. Br. 19-20) two purported explanations for the inclusion of the state tax prohibition in the OCSLA. Both of these reduce this important provision to little more than a technical correction, however, and are not supported by the legislative history.

First, the Solicitor General argues that Congress simply sought to ensure that the Buck Act (4 U.S.C. §§ 105 *et seq.*), which consents to otherwise impermissible state taxation in federal enclaves. would not be included among the "laws * * * of the United States" that the OCSLA extended to the outer Continental Shelf (43 U.S.C. § 1333(a)(1)). But the Solicitor General has not cited —and we are not aware of—a single passage in the legislative history that indicates that the state tax prohibition was designed to exclude the Buck Act. On the

contrary, where Congress intended to exclude a particular statute from the scope of 43 U.S.C. § 1333(a)(1)—as it did in the case of the Mineral Leasing Act of 1920, 30 U.S.C. § 189—it said so expressly in Section 1333(a)(1) itself and discussed the question explicitly and at length in the legislative debates (see Shell Br. 29-30 & n.19). In any event, the OCSLA's extension of federal law was intended to assert the exclusive jurisdiction of the United States over the OCS, not to waive it; inclusion of the Buck Act would have subverted that congressional intent.

Second, the Solicitor General argues that Congress merely wanted to make clear that state tax laws were not "borrowed" as surrogate federal law under 43 U.S.C. § 1333(a)(2)(A). But again, the legislative history provides no indication that this was the purpose of the state tax prohibition. More important, common sense suggests that that could not have been its purpose. If state tax laws had been adopted as "the law of the United States" to be "administered and enforced by the appropriate officers and courts of the United States," as Section 1333(a)(2)(A) provides, the revenue from those taxes on the OCS would have gone to the *federal government*, not the states. Yet the debate in Congress over the state tax prohibition was whether the *states* were entitled to raise money for their own treasuries by taxing OCS oil and gas. The Solicitor General's reading of the state tax prohibition renders the statute nonsensical.

Rather than the purposes ascribed by the Solicitor General, it was Congress's intent in enacting the OCSLA to facilitate development of the OCS. See Shell Br. 33-41. Neither Iowa nor the Solicitor General explains how this crucial congressional objective is furthered by their trivializing interpretation of the OCSLA. Quite the opposite, the Solicitor General concedes (U.S. Am. Br. 28-29 n.18) that Congress passed the state tax prohibition

because state taxation would adversely affect the federal government's interest in the OCS leasing program (see also Shell Br. 35-36); while the Solicitor General strives to narrow this congressional concern to extraterritorial state taxes, including unapportioned state income taxes (see U.S. Am. Br. 28), the same policy is equally applicable to apportioned state income taxes. The Solicitor General and the states simply disregard one of the principal guides to the proper construction of the state tax prohibition.[1]

That the Constitution may not proscribe the application of Iowa's apportionment methodology here—a question that Shell has elected not to raise in this case—does not mean that state taxation is consistent with the OCSLA. It is, after all, a statute that is at issue. Formula apportionment may be sufficiently "rational[]" to withstand constitutional scrutiny, but it is at best "a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State" and "generally will not produce a figure that represents the actual profits earned within the State." *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 273 (1978). While "the Court has refused to impose strict constitutional restraints" on formula apportionment "despite this imprecision" (*ibid.*), Congress was not required to be content with the same rough approximation as adequate to promote important national policies in this area of exclusive federal authority. There can be no doubt that Iowa generally imposes a higher tax on Shell by attracting income to the State through the use of formula apportionment. See Shell Br. 10 n.7, 22-24. Such taxation stands as an obstacle to the achievement of Congress's purpose in the OCSLA.

[1] Iowa objects (Br. 13, 36-38) that our interpretation of the OCSLA would not promote OCS development because it could result in higher state taxes in the start-up years of exploration and production when off-shore operations are likely to be unprofitable. This ignores the business reality that, as Congress undoubtedly understood, no company would undertake OCS development unless it expected a profit over the life of the project; an investment of this kind necessarily requires a long-term perspective. Congress's choice of a state tax immunity for OCS income thus accords with the nature of the business decision that an oil company must make. "It is not [the] function [of the courts] to speculate whether * * * one type of tax [immunity], as contrasted with another, is wise. That is a question solely for Congress, acting within its constitutional sphere, to determine." *Federal Land Bank* v. *Bismarck Lumber Co.*, 314 U.S. 95, 104 (1941).

For this reason, the Solicitor General is wrong in contending (U.S. Am. Br. 5, 12) that *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980), is contrary to our position. That case involved an interpretation of the Constitution, not a federal statute. What is more, the Wisconsin tax expressly required separate accounting rather than apportionment for the income of a unitary oil company's sales of oil and gas to third parties at the wellhead (see 447 U.S. at 226 n.10).

Likewise, *Polar Co.* v. *Andrews*, 375 U.S. 361 (1964), which the Solicitor General discusses at some length (see U.S. Br. 17-18), does not refute our construction of the OCSLA. Once again, *Polar Co.* was a constitutional rather than a statutory decision. In addition, the nature of the tax in *Polar Co.* was fundamentally different from the apportioned income tax in this case.

Polar Co. held that Florida constitutionally could "attach" (375 U.S. at 382) a milk processing tax to the privilege of engaging in the milk business within the State, notwithstanding that some of the milk was ultimately sold and delivered to a federal military installation. See *United States* v. *Mississippi Tax Comm'n*, 412 U.S. 363, 371 (1973) (distinguishing *Polar Co.* on the ground that, "with respect to the initial sale and delivery of the liquor by the suppliers to military facilities located in exclusively federal enclaves, nothing occurs within the State that gives it jurisdiction to regulate the

initial wholesale transaction"). By like reasoning, Iowa (or any other state) could impose a sales or gross receipts tax on the in-state sale of equipment destined for the OCS or an ad valorem property tax on OCS oil stored in the State. See Iowa Br. 34-35. Shell has never contended otherwise. But such taxes, in contrast to Iowa's apportioned income tax, are not levied on Shell's OCS income and do not interfere with Congress's policy of encouraging OCS production by shielding that income from state taxation. It is for that reason that the OCSLA condemns Iowa's income tax as applied in this case.

II.

Both Iowa (Br. 14 n.7) and the Solicitor General (Br. 15 n.10) concede that Congress has the power to immunize income from state taxation in order to promote paramount federal policy. See also *South Carolina* v. *Baker*, 108 S.Ct. 1355, 1364 n.10 (1988). Nevertheless, Iowa argues (Br. 27, 32-33, 39) that, because of the importance of taxation to the states, Congress should be held not to have exercised that power unless it manifestly and unmistakably so provides. Accordingly, while explicitly acknowledging (*id.* at 26) that Shell's reading of the OCSLA is consistent with the statutory language, Iowa urges that such an interpretation should be rejected because "the OCSLA do[es] not *clearly* indicate a *facial intent*" to limit apportioned state income taxes (*id.* at 12 (emphasis added)).[2]

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[2] The Solicitor General's position may reflect the same consideration. President Reagan's Executive Order on "Federalism" directs the Department of Justice to "construe, in regulations and otherwise, a Federal statute to preempt State law only when the statute contains an express preemption provision or there is some other *firm and palpable evidence compelling the conclusion* that the Congress intended preemption of State law, or when the exercise of State authority directly conflicts with the exercise of federal authority under the Federal statute." Exec. Order No. 12,612, 52 Fed. Reg. 41,685, 41,686 (1987) (emphasis added). As we explain in the text, this Court's decisions have never applied that test to federal statutes granting state tax immunity.

As discussed above, the interpretation of the OCSLA we propose is necessary to give meaning to the state tax prohibition and effectuate Congress's policies. Iowa's position, by contrast, renders the state tax prohibition a dead letter. Such a result is impossible to justify under any rule of statutory construction.

But beyond that, slogans such as "[t]axation is a fundamental and historical power of a State" (Iowa Br. 32-33) are of no help in interpreting the OCSLA. It is clear from the text of the statute that Congress was aware of and intended to limit this "fundamental and historical power" of the states. The nature and extent of that congressional limitation must be resolved by reference to the language, history, and policies of the OCSLA, which demonstrate that states may not impose a tax of any sort on OCS income.

Contrary to Iowa's argument, this Court has not applied the kind of special and exceptionally stringent rules of construction to which the State is forced to resort. Rather, the Court has followed its usual course of attempting to determine "the more persuasive construction" of tax immunity statutes under customary principles of interpretation, no matter how "flickering and feeble the light afforded [by Congress] for extracting its meaning." *Offutt Housing Co.* v. *Sarpy County*, 351 U.S. 253, 260 (1956). Indeed, the Court has rejected the argument that Congress's enactment of federal tax immunities is subject to different rules because "the power to tax is basic to the sovereignty of the states." *Dameron* v. *Brodhead*, 345 U.S. 322, 329 (1953) (Douglas, J., dissenting). And in fact the Court has "liberally construed" federal tax immunities where appropriate to the achievement of Congress's purposes. See, *e.g.*, *Porter* v. *Aetna Casualty & Surety Co.*, 370 U.S. 159, 162 (1962).

None of the opposing briefs disputes our contention (Shell Br. 31-32) that the only portion of the OCSLA legislative history that specifically refers to state corporate income taxation is Senator's Long's statements—which were made both in the Committee Report and in floor debate, and to which no disagreement was voiced—that OCS lessees would not be subjected to "the tax on corporate profits." Despite the singular importance of these statements, Iowa (Br. 30) and the Solicitor General (Br. 29) seek to minimize their relevance because they were made in opposition to the OCSLA. However, the views of opponents are "relevant and useful" in construing a statute, "especially where, as here, the proponents of the bill made no response to the opponents' criticisms." *Arizona* v. *California*, 373 U.S. 546, 583 n.85 (1963). See also, *e.g.*, *United States* v. *Sheffield Bd. of Comm'rs*, 435 U.S. 110, 130-131 (1978) (statement of opponent "possesses significant pertinence," particularly since proponents "did not disagree"). No sound canon of construction requires the Court to close its eyes to the most direct evidence in the legislative record of Congress's intent on the very question presented in this case.

Iowa concedes (Br. 30 & n.18) that Senator Long's statements can fairly be understood to prohibit states from including OCS income in the apportionable tax base. It nevertheless asserts that Senator Long's seemingly inclusive remarks, although "not clearly express-[ing] th[is] distinction" (*id.* at 30), simply did not apply to apportioned taxation. There is no support whatsoever for the State's inference, however, and it flies in the face of the fact that Louisiana levied an apportioned corporate income tax and had done so for some two decades at the time the OCSLA was enacted (see Shell Br. 32).

In the same vein, the Solicitor General argues that, because Louisiana law allowed the use of separate accounting in certain circumstances, Senator Long's statement should be read to "refer[] to an *un*apportioned income tax measured by separate accounting" (U.S. Am. Br. 28) rather than to an apportioned tax. This is a perverse and wholly unnatural reading of Senator Long's remarks. First, as the government admits, Louisiana "generally utiliz[ed] an apportionment formula" to tax corporate profits (*ibid.*). Both the Louisiana tax statute (La. Rev. Stat. Ann. § 47:244 (West 1970)) and the decision upon which the government relies (*Texas Co.* v. *Cooper*, 236 La. 380, 107 So.2d 676 (1958)) make clear that separate accounting constituted an exception to the normal apportionment procedure, available only if the party seeking to use separate accounting satisfied the burden under the statute of "show[ing] that the apportionment method produces a manifestly unfair result." Furthermore, a number of large oil companies had refining or other facilities in Louisiana and therefore did not come within the separate-accounting exception cited by the government.[3] It is therefore most unlikely that Senator Long's unqualified statements were meant *sub silentio* to focus exclusively on a narrow exception to Louisiana's method of corporate income taxation and to exclude the State's principal taxing methodology: formula apportionment.[4]

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[3] In fact, it was not until 1958—well after enactment of the OCSLA in 1953—that the Louisiana Supreme Court clarified the circumstances in which the State could require a taxpayer to use separate accounting.

[4] In *Texas Co.* (see 236 La. at 413-414, 107 So.2d at 688), as here (see Shell Br. 7), the income attributable to the production of oil was determined by means of separate accounting based on fair market value. The Louisiana Supreme Court specifically rejected the argument that "no value can be assigned to the oil produced in Louisiana which was, instead of being sold upon the open market, shipped to appellant's self-owned refinery in Texas" (236 La. at 420, 107 So.2d at 690). See Shell Br. 2 & n.1.

The Solicitor General further argues that Senator Long's statements do not relate to formula apportionment because they were "expressly premised on the assumption that a private lessee such as Shell would not be engaging in activities within the taxing State's borders" (U.S. Am. Br. 28), which is the predicate for apportioned taxation. The government's assertion reflects a misreading of Senator Long's remarks. As explained in our opening brief (at 32), Senator Long understood that OCS development would require lessees to have substantial on-shore operations that could be taxed by the states. See S. Rep. No. 411, 83d Cong., 1st Sess. 66-67 (1953) (minority views):

> [T]he Federal Government is receiving the benefit of State services for the support of all activities on shore which are of a larger scope and a greater expense than the actual drilling operation in the sea. Thus we find here a source of wealth * * * which cannot be fully exploited or developed without the benefit of State services from the mainland.
>
> * * * * *
>
> Many of these same services will be provided for the oil company whose base of operations will be necessarily on Louisiana soil. The company will use our highways, will benefit from police protection, and make use of our courts.
>
> None can deny that the furnishing of such services to the thousands of shelf workers, their families, and the companies for which they work will be a heavy financial burden on the State and its subdivisions.

See also 99 Cong. Rec. 7261 (1953) (remarks of Sen. Long). In light of those in-state activities, there is absolutely no reason to assume that Senator Long's statements somehow were intended to exclude apportioned taxation of OCS income. While the Senator noted that states could not impose any tax—a "severance tax," a "property tax," or a "tax on corporate profits" (S. Rep. No. 411 at 67; 99 Cong. Rec. at 7261)—with respect to OCS operations, that hardly suggests an "express[] * * * assumption" (U.S. Am. Br. 28) that OCS lessees would not be engaged in in-state activities that would provide a sufficient nexus for an apportioned income tax.

III.

In large part the position of Iowa (Br. 11, 17, 20 n.13) and the Solicitor General (Br. 13 n.8) amounts to an attack on the concept of separate accounting. If, however, as we have shown, the OCSLA requires that OCS income be excluded from the apportionable income base, separate accounting would be the customary—if not the only—method for making the necessary adjustment.

Moreover, Iowa and the Solicitor General greatly overstate the difficulty of determining OCS income and expenses. Separate accounting is a generally accepted methodology used for a variety of tax (as well as corporate accounting) purposes. For example, the Internal Revenue Code and implementing regulations provide for separate accounting in a number of contexts and prescribe specific rules for its use. See, *e.g.*, 26 U.S.C. §§ 861 *et seq.* and Treas. Reg. § 1.861-8 (tax based on income from sources within or without the United States); 26 U.S.C. § 482 and Treas. Reg. § 1.482-1(d)(1) (adjustment of income and deductions between commonly owned organizations or businesses). Likewise, separate accounting has been widely used by the states: three states currently *require* separate accounting in their corporate tax system (Louisiana, Mississippi, and Oklahoma), and other states previously have done so (see, *e.g.*, *Atlantic Richfield Co.* v. *Alaska*, 705 P.2d 418 (Alaska 1985), appeal dismissed, 474 U.S. 1043 (1986); *Exxon Corp.*, discussed at page 5, *supra*). Indeed, the Solicitor General recognizes as much in his discussion of the Louisiana corporate tax system, see pages 8-9, *supra*. Notwithstanding our opponents' complaints, therefore,

separate accounting is a valid and well-accepted methodology.[5]

This case is not, as some of the *amici* states attempt to portray it, a frontal assault on formula apportionment that "goes to the very heart of the entire unitary method" (Calif. Am. Br. 2) and "would seriously erode the unitary business principle" (N.J. Am. Br. 1). Once again, these overblown assertions ignore the fact that the question presented here turns on a congressional statute, and separate accounting is simply the means of effectuating a specific tax immunity that Congress adopted as a matter of federal policy. Thus, there is no basis for the concern expressed by the states (Calif. Am. Br. 10) that "[i]f [Shell] can use separate accounting to carve out this particular portion [of income], what is to prevent others from using separate accounting to carve out other portions attributable to foreign countries, federal enclaves, Indian lands, and other states, until the entire unitary method is in tatters?" States have the power to prevent the use of separate accounting, unless it is required by the federal Constitution or, as here, a federal statute.

Furthermore, our construction of the OCSLA is not rebutted, as Iowa contends (Br. 20, 36), by the fact that the statute does not contain detailed standards for computing the OCS income that is exempt from state taxation or ensuring that uniform rules are applied by the states. Congress understandably could have left the formulation of such implementing standards to the courts (or the responsible federal agencies), just as it has done

[5] Iowa also criticizes (Br. 7, 18 n.11) Shell's application of separate accounting principles for not attributing certain expenses (such as refining costs) to the OCS. But of course Shell has no refining operations on the OCS, and therefore those costs are irrelevant in determining the net wellhead value of Shell's OCS oil and gas production. In any event, if the Court were to hold that the OCSLA requires that the states exclude income earned on the OCS, Iowa would have the opportunity on remand to challenge Shell's calculations.

under 31 U.S.C. § 3124(a). In addition, even if the determination of OCS income were made by the respective states, the potential for some variation in applying the statute would not be a fatal inconsistency with the OCSLA, provided that each state's methodology furthers rather than impairs the purposes of the Act. And in any event formula apportionment does not avoid the problem of inconsistent state taxing schemes. See *Moorman Mfg. Co.*, 437 U.S. at 276-281. Iowa's solicitude for national uniformity is a flimsy—and an ironic—justification for allowing the 50 states *carte blanche* to include OCS income in the apportionable base on which their income taxes are laid.[6]

[6] The Solicitor General also relies (U.S. Am. Br. 21 n.14) on 43 U.S.C. § 1335(a)(9), which provides for an increase in OCS royalties by the amount of "severance, gross production, or occupation taxes" payable to the state under leases it issued prior to the enactment of the OCSLA. Because the OCSLA unquestionably prohibits these taxes, and because the purpose of Section 1335(a)(9) was to prevent a windfall to existing lessees who were being relieved of state taxes they had expected to pay, the Solicitor General suggests that the absence of apportioned state income taxes from this enumeration means that they are not covered by the OCSLA state tax prohibition. However, given the differences in computing taxes based on net income and taxes (like severance, gross production, and occupation taxes) based solely on the volume of production, it would have been completely infeasible to add to the federal royalty payment the amount of the state income tax that would have been due. Indeed, Section 1335(a)(9) does not refer to unapportioned state income taxes on OCS operations, which Iowa (Br. 30) and the Solicitor General (Br. 28) concede the OCSLA prohibits. Moreover, Section 1335(a)(9) applies only to leases issued by the state prior to the enactment of the OCSLA; for all subsequent leases, the federal royalty is *not* increased by the amount of the prohibited state tax, a result that Congress recognized would inure to the advantage of OCS developers over their competitors operating on the mainland and subject to state taxation. See 99 Cong. Rec. 2575 (1953) (remarks of Rep. Ikard and Rep. Wilson); *id.* at 2577 (remarks of Rep. Brooks); *id.* at 7259 (remarks of Sen. Daniel).

Finally, the OCSLA requires that, at a minimum, the apportionable tax base exclude OCS income earned from sales to third parties on the Shelf. See Shell Br. 44-45; see also page 5, *supra*. The Solicitor General initially agreed with this interpretation (see U.S. Am. Br., *Shell Oil Co.* v. *Florida Dept. of Revenue*, appeal pending, No. 86-1593), but he has now reversed that position and urges the opposite meaning of the statute. The Solicitor General's about-face before this Court within a matter of months certainly casts doubt on the validity of his current construction of the Act. Likewise, in the related *Florida Dept. of Revenue* case, Florida conceded in the state Supreme Court that the OCSLA prohibited inclusion of on-shelf sales in the tax base, but it too now seeks to disavow that concession in the *amicus curiae* brief it has filed here (Fla. Am. Br. 26-30).

As discussed in our reply brief (at 4-6) at the jurisdictional stage in this case, the Solicitor General and Florida cannot escape from their prior positions through a revisionist characterization of the tax imposed on Shell. In addition to the reasons there stated, Florida's repudiation of its earlier concession is especially unconvincing. First, it is logically inconsistent for the State to assert that it uses a one-factor sales formula to determine the excludable income that is attributable to sales on the OCS, but that it uses a three-factor formula of property, payroll, and sales to determine the income attributable to sales within the United States. Moreover, Florida's representation does not in fact accurately describe either the State's statutory and regulatory tax system or what the State did in Shell's tax case; indeed, the State in its brief in the Florida Supreme Court explicitly commented (at 22) that "[t]he OCS, of course, is not outside the United States," and therefore that sales on the OCS would not be excluded from the tax base as a matter of state law. Florida's new-found position appears to be nothing more than a *post hoc* rationalization

advanced by the State's appellate lawyers in an effort to evade their earlier concession as to the meaning of the OCSLA state tax prohibition.

CONCLUSION

For the foregoing reasons and those stated in our opening brief, the judgment of the Supreme Court of Iowa should be reversed.

Respectfully submitted.

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